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Europe facing a new political economy

Mr. President, Ladies and Gentlemen,

Thank you for your invitation. I am grateful for the opportunity to speak here in Madrid today with my friend Governor L. Linde, in the midst of the Spanish financial community, and in a country which has demonstrated its active commitment to the European project since it joined the European Union thirty years ago. We have come a long way in Europe and our common history and past success will help us look ahead in these challenging times. The Brexit referendum in June and Mr. Trump's victory two weeks ago have indeed come as shocks for Europe: both have increased uncertainty and are raising questions about the European identity. How should we, as Europeans, react? Not by less Europe: this would clearly be a mistake if we want to collectively master our own destiny in this new world. But by a better Europe, a more focused and efficient one. In concrete terms, we need to adapt in two ways: first, by building actively on our economic and social assets – among them our single currency and monetary policy; second, by coming together around a few new select priorities – including tackling the current "investment crunch".

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I. First, Europe's assets in the new "political economy".

Let me start with a brief remark about terminology. For a long time, economic thinkers used the term **"political economy"** to refer to the discipline that we now call "economics". Adam Smith, David Ricardo or Léon Walras, to name but a few, were some of its exponents. Despite its 400 year-old history, the term "political economy" had in the last decades gradually lost its importance as a comprehensive way of understanding economic issues. And yet it could now be returning to the forefront, given the strong interactions between politics and economics. At the international level, we cannot yet predict what Mr. Trump's presidency will really be like, but we can expect a deep political shift, with consequences for American economic policies. Besides, the electoral cycle will continue in Europe, starting with the Italian referendum in December. To state the obvious, the first certainty is that we are facing a lot of uncertainty. How will Europe overcome this? I sincerely hope not by "waiting and seeing", but rather by sticking to and building further on **its three shared economic and social assets: its single currency, its single market, and its unique social model.** We must actively build on them, and not lazily rest on our laurels: pride should not be confused with complacency.

First, with the **euro**, we share a solid currency which is recognised worldwide. The vast majority of euro area citizens are attached to it (68% according to the latest Eurobarometer[i]). Moreover, in a world of uncertainty, European monetary policy is a yardstick of stability. Within the ECB Governing Council, around Mario Draghi, we take very seriously the task entrusted to us by the European Treaties of maintaining price stability, meaning medium-term inflation of close to but below 2%. Our monetary policy has safeguarded the euro area against the threat of deflation in recent times, and is achieving tangible progress towards our inflation target: inflation rose to 0.5% in October and should exceed 1% in early 2017. It is supporting demand while narrowing the output gap, which has been reduced from -2.4% in 2014 to -1.0% in 2016 according to European Commission estimates[ii]. The Eurosystem has already provided ample liquidity to the European economy: our holdings under the expanded asset purchase programme amounted to nearly EUR 1,400 bn in October 2016.

We can take stock of this progress, while remaining alert to the latest financial developments and their mixed economic effects: the rise in the equity market but also in the long term interest rates; the appreciation of the dollar but quasi-stability of the global euro exchange rate; and the increase in inflation expectations. We should be both confident in our progress, and vigilant with respect to our environment. Until March, we will go on implementing exactly what we said we would: our clear success today in purchasing a volume of EUR 80 bn of assets per month, including corporate bonds, is the best guarantee of our credibility tomorrow. I am fully confident that in our next monetary meetings, in the coming months, we will decide, in a pragmatic approach, about the best evolution after March of all our available tools: QE, TLTRO and forward guidance on interest rates. And we have many options open regarding the size and length of instruments like our APP, excluding either a sudden stop of its contribution to our accommodative policy in March, or the continuation of the same contribution forever.

Second, we in Europe share a large **single market**. It is a tremendous asset which belongs to us all, the 27. It is no coincidence that access to the single market lies at the heart of the Brexit debate. We cannot prejudge the outcome of the future negotiations, but we can be sure of one consistency principle: access to the single market must continue to go hand-in-hand with strict acceptance of all its rules. There can be no cherry-picking or free-riding. And we must obviously preserve the single European trade policy, if we want to exist in the trade negotiations to come worldwide.

Third, we share a common **social model** (slide 2) which combines high standards of public service and relatively low levels of inequality – much lower than in American society. And this has been achieved in a market economy. At a time when globalisation may leave many behind in advanced economies, when the debate about inequalities is coming back to the forefront – and these are real challenges behind the populist wave –, now is not the moment to give up on our social model. But this ambition must be clear-sighted: in some countries like France and Italy, the high cost of the model and its disappointing performance in terms of growth and employment calls for an acceleration in reforms in the right direction (slide 3). Several European countries, including Germany and Spain, are showing the way forward: they have succeeded in carrying out wide-reaching reforms that are compatible with our shared social model. Progress has been made in all four key areas: Enterprise, Employment, Education and Expenditure reduction. And these reforms are delivering results today: in recent years, GDP and employment have grown much faster in the "reforming" countries, than in France or Italy for instance.

II. Beyond our existing assets, we in Europe must put our joint energies into mastering our common destiny.

Europe needs all Member States to play their part in the common effort. It needs France, as well as Spain and its constant European commitment. For this to be a success, projects for strengthening Europe have to be carefully selected and prioritized; and we must not only talk about them, we must give ourselves the practical means to achieve concrete results. In a nutshell: "few, well, till the end", or in Spanish if I may, "*poco, bién, hasta el final*". There are of course non-economic areas: to name a few, defence and border protection; climate change; or youth education and training – an Erasmus Pro programme should be a priority for the unskilled and unemployed youth, which is our common tragedy in France, Spain and Italy. But in the economic field, much remains to be done as well. Although we have succeeded with *monetary* union, we must make progress towards *economic* union – so that monetary policy does not remain the only game in town.

1. The first economic priority is to address the root causes of Europe's continuing subdued growth; and a major one is what I call the "investment crunch".

(Slide 4) Many, following Ben Bernanke's speech of March 2005, have rightly talked about the "global saving glut" that was putting pressure on the world's economies. At present, saving remains high, due to the combination of emerging market economies' surplus and advanced countries' aging populations. However, (slide 5) what has dramatically changed since the 2007-08 crisis is investment, which has dropped sharply as a share of GDP in advanced economies. In the euro area, the total investment to GDP ratio has dropped by around 3 points since the 2007 peak and has only slightly recovered since. The gap between savings and investment is therefore huge: the current account surplus reached EUR 350 billion on a yearly basis in August 2016, which is more than 3% of GDP. This **"investment crunch"** – rather than the "saving glut" – is holding back our growth.

It is true that part of the decline in total investment since the crisis has come from a drop in real estate investment: it was booming before the crisis, especially in countries experiencing real estate bubbles such as Spain. But what matters the most for our long term growth is **business investment** – and more precisely "productive investment" (slide 6): this includes investment in research and development and industrial machinery, as opposed to investment in construction which in itself does not spur innovation. One issue for concern is that the productive investment rate has long remained below its pre-crisis level in the euro area. What is more, it has been weaker in France and Spain than in the euro area as a whole, although it has been recovering in recent years especially in Spain. These developments have translated into a striking change in businesses' behaviour (slide 7): since mid-2009, euro area non-financial corporations have turned from net borrowers into net lenders, thereby fuelling the euro area current account surplus.

2. To address the "investment crunch", we need a comprehensive therapy, both economic and financial.

On the **economic** side, business investment depends indeed on two levers (slide 8). The first one is **expected demand**. Banque de France research[iii] based on a panel of 22 advanced economies shows that over the 1996-2014 period it has been the main determinant of the slowdown in business investment (negative contribution of 80%). The second lever is **confidence** or, in other words, the level of uncertainty (17%). Concretely, rules have to become simpler and more stable for entrepreneurs. In France and Spain, we are still far from the best performers in the latest World Bank 'Doing Business' ranking: we came in 29th and 32nd respectively[iv].

But alongside the economic levers, **financial levers** play a role too (slide 9). As Europe's economy is close to the "technological frontier", businesses need to innovate more. As such, they need to be able to take more risks, which means more equity financing, rather than debt financing. But Europe is lagging behind: equity capital amounts to only 52% of GDP in the euro area, compared with 121% in the United States. In addition, (slide 10) the cost of equity (CoE) has remained astonishingly high on both sides of the Atlantic – more than 9% for large listed companies in the euro area according to Banque de France calculations – despite the sharp fall in interest rates over the last two decades. This means that the risk premia have increased. The high CoE could prompt companies to give priority to dividends and share buybacks over investment – we have seen this situation occurring in the United-States.

So, in practice, what is the way forward? Obviously, as I argued earlier, we need economic and social reforms at the national level. But a large part of the solution lies at the European level as well: (slide 11) as of today, Europe needs what I call a **"Financing and Investment Union"** (FIU) to steer abundant savings into productive investment. The FIU would merge together the initiatives already in place, which do not deliver sufficient results: the Capital Markets Union of course, but also the Juncker Plan and the Banking

Union. We need to put the pieces of the puzzle together in order to magnify their impact through synergies. There are two objectives: increased diversification of firms' financing – with more equity financing, and higher resilience of the euro area thanks to private risk-sharing across domestic borders.

3. Beyond the "Financing and Investment Union", which is the first step, I believe that Europe should move forward on two further concrete steps.

The second step, after the FIU, is a **collective economic strategy** for the euro area. Growth and employment will be stronger in Europe if we combine more reforms where they are needed, such as in France and Italy, and more fiscal support in those countries with room for manoeuvre, such as Germany. In practice, for such a collective economic strategy to exist, the euro area needs to overcome the current sense of distrust. So it needs an institution that fosters confidence: it could consist of a euro area "Finance Minister". He would be responsible for defining the collective strategy with the Eurogroup, and for ensuring it was implemented in each country. He would also be tasked with managing a reinforced ESM (European Stability Mechanism). In terms of timing, this second step can only reasonably come after the elections scheduled for next year in some euro area countries, as it requires modifying the European Treaties.

The third step, in the longer term, would be to complete the Economic and Monetary Union with a **European fiscal capacity**. This involves gaining more trust from Member States, to avoid it being seen as a one-way "transfer union". A genuine euro budget would be a stabilisation tool and could include, for example, a European-wide unemployment insurance scheme. It could also be used to finance certain "European public goods" such as digital technology, the energy transition or the integration of refugees. And in the long term, it could directly issue common debt and even raise taxes.

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Let me sum up. To withstand the current global headwinds, we in Europe must safeguard our three common economic and social assets. And we cannot just wait for better conditions: as a central banker, I have given you my views on the path we can take in the economic area. It is now time for Europeans to embark on some decisive actions to be able to look to the future with confidence. As put by José Ortega y Gasset, the famous Madrid-born philosopher: "Life is a series of collisions with the future; it is not the sum of what we have been, but what we yearn to be". Thank you for your attention.

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[i] European Commission, Standard Eurobarometer 85, July 2016.

[ii] European Commission, European economic forecast, Autumn 2016.

[iii] Matthieu Bussière, Laurent Ferrara and Juliana Milovich, 'Explaining the recent slump in investment: the role of expected demand and uncertainty', Banque de France WP No. 571, September 2015.

[iv] World Bank, Doing business 2017 report.